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Laughlin, James Laurence

Banking control

Chicago

[1911?]

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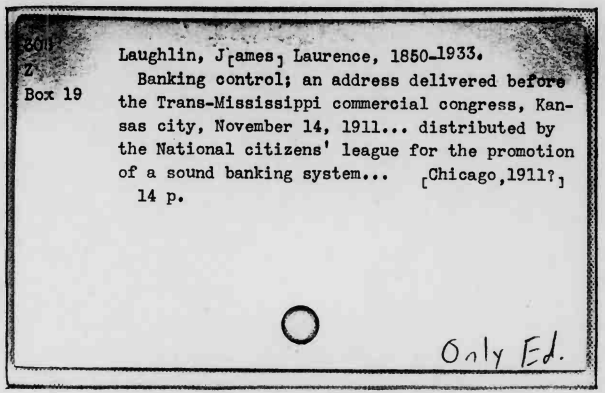
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THE NATIONAL CITIZENS' LEAGUE

FOR THE PROMOTION OF A SOUND BANKING SYSTEM

BANKING CONTROL

BY

J. LAURENCE LAUGHLIN

DISTRIBUTED BY
THE NATIONAL CITIZENS' LEAGUE
225 WEST JACKSON BOULEVARD · CHICAGO

THE NATIONAL CITIZENS' LEAGUE

FOR THE PROMOTION OF A SOUND BANKING SYSTEM

223 West Jackson Boulevard CHICAGO, ILLINOIS

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Wisconsin, W. H. HATTON, New London

And others to be named

Banking Control

An Address

Delivered before the Trans-Mississippi Commercial Congress, Kansas City

By

J. Laurence Laughlin

November 14, 1911

Distributed by

The National Citizens' League

For the Promotion of a Sound Banking System

223 West Jackson Boulevard

CHICAGO

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BANKING CONTROL

I

DEFECTS OF THE PRESENT SYSTEM

FOR years a human organism may go on with poison within its tissues, suffering constantly and grievously without the true cause being definitely determined. For decades our business community has been suffering enormous losses from an unhealthy condition of our banking and credit system; but now we are beginning to locate the disease. We notice that other countries are free from most of the frequent paroxysms of credit with which we are afflicted. Then, we notice that, when a reversal of business comes to us, how peculiarly the power of our banks to lend to the business public is crippled by the rigidity of our ill-regulated credit system. It is to the interest of the borrowing public—the producer, the jobber, the retailer, and their employes who depend on prosperity for employment—to find a remedy for this rigidity and for its losses. For a long time we have been thinking that this rigidity was due to the inelasticity of our banknote issues; and there is much in that belief. But the difficulty with the note-issues is only a manifestation of some cause deeper down, which must be reached before we can apply the effective remedy. Without doubt the fundamental difficulty is to be found in the rigidity and inelasticity of our organization of credit. Correct that, and the correction of the inelasticity of our note circulation will go with it. Let me make this clear.

The business world regularly depends upon an element of borrowed capital in conducting its legitimate work of producing and exchanging the commodities of general consumption. When exceptional demands for cash are made in the autumn for moving cotton and grain, there is an increase in the demand on the banks for loans, and the cash reserves decline. Likewise, but on a greater scale, when a commercial collapse comes, the pressure on the banks to meet exceptional demands, either for extensions or new loans, is appalling and dangerous.

The producer, who has borrowed to pay for his materials or pay roll, cannot meet his debt, if he cannot collect from the jobber; the jobber, who has borrowed to pay for the finished goods, cannot meet his note, if he cannot collect from the retailer; and, in turn, the retailer, who has borrowed to pay the jobber, cannot meet his obligation, if goods are not salable. Hence, if loans are stopped, the whole machinery of exchange comes to a practical standstill, just as an engine would stop if a crowbar were thrust into the cylinder. There is just as much money as before in circulation. There is no lack of a medium of exchange. If a man has funds on deposit, they can be transferred by a check. What, then, is wrong? The rigidity of our organization of banking and credit.

A situation already dangerous is aggravated by the feeling that banking preservation depends upon grasping by hook or crook for reserve money. When alarm is felt in this country, there is no other recourse at present but trying to heap up reserve money; consequently, incidents which would cause no real disturbance in foreign countries, would tend to bring disaster here. The critical situation produced by an unreasonable demand for cash hinges upon one elemental fact to which our public is usually blind. Demand obligations in the form of deposits are principally the outcome of credits resulting from loans; and these loans are commonly based, directly or indirectly, on transactions in goods, such as cotton or grain. Hence these transactions, and the resulting loans and deposits, are obviously far and away greater in amount than the supply of actual cash kept during normal conditions in the hands of the public or the banks. Now, when uninformed persons begin to draw cash for their demand obligations at a bank, of course all cannot get it. The bank has sound assets in the short-time paper on which the loans are based; and this paper represents goods which, if business continues normal, and sufficient time is allowed, will always liquidate the loan. But no reserve can ever by any possibility equal all the deposits.

Under our present system of rigid legal reserves and antiquated usury laws, banks find it impossible to lend just when loans are most needed. When a reversal of business comes, men ought to be given time to dispose

of their goods and securities without the frightful loss due to forced and immediate sale. If legitimate business men can be given a loan, and time to work out of difficulty, ruin is avoided. The safety of the industrial and business world depends upon the power of the banks to make loans. Under our present banking organization, absolutely destructive conditions arise as soon as danger appears. Whenever there is a needless demand for cash —from either individual depositors or from correspondent banks—it draws down reserves. The legal ratio of reserves to deposits is quickly reached (and in fact usually over-passed), and the lending power of the banks is strangled. This is a crime against society. It is diametrically opposed to the practice of the advanced countries of Europe. In Europe, in an emergency, the banks increase their loans, and their deposit (or note) liability, and at the same time pay out their reserves; that is, they work to aid the business public. In this country, we slam the door in the face of the borrower just when he is in the greatest need. This is why we have panics which other countries escape. This is why the great business world is now demanding a reform in the interest of the borrower and of the workingman.

Compare the accounts of European and American banks in times of crisis. The former show that, at the height of the pressure, the note or deposit item was in every instance largely increased because of new loans, while the cash reserves were freely paid out; that is, the banks retained their lending function and aided the business public just when help was most needed. On the other hand, with slight exceptions, the accounts of our country and reserve-city banks, in such panics as those of 1893 and 1907, show a liquidation and decline of the deposit item, due to a refusal to extend, or to make new, loans, while the cash reserves actually increased, instead of being paid out; that is, when reserves fell to the legal limit, our banks suddenly abdicated their lending function— refused to lend just when loans were most needed. Such an outcome of our disorganization of credit is certainly intolerable; it affects the borrowing public and the industrial workman more than the banks; and it would be hardly less than criminal to allow it to continue.

Moreover, there are other serious defects to be cured. We have to-day a practical centralization of credit,

which is very undesirable. Precisely because we have had no organization of credit, we find the small bank, or the small borrower, at the mercy of the big fellow who has the power of great bank deposits under his control. Much of the talk about "Wall Street" and the "money power" is no doubt exaggerated by those who are largely ignorant of the facts. But there is apt to be some fire where there is so much smoke. One does not need to be very discerning to know that to-day, in times of pressure, certain persons or institutions are favored to the neglect of others who have quite as good bankable paper. When a financial upheaval comes, the bank having large resources has its own troubles, of course; but, at the worst, it can protect itself by sacrificing some of its customers. It is the small institution that must go down on its knees to seek help, as a favor, from those who can grant it. This is the situation which excites so much irritation in the minds of thinking business men. In other words, exactly because of our lack of an organized banking and credit system, we have a situation in which, unquestionably, the strong more or less dominate the weak; in which central control over credits is a practical fact; and in which this central control, being unauthorized and irresponsible, is difficult to locate and harness. Now and then we hear opposition expressed to a central bank; but, curiously enough, we do not seem to realize that we have today a centralization of the most effective kind. Because we have no regulation of credit, we have no liberty for the small borrower. Therefore, what we must now strive for—as in all other great democratic movements—is liberty under law, to the end that all banks—large and small—shall be placed on an essentially equal footing.

II

PROGRESSIVE TENDENCIES

In the middle ages, the poor man and the weak huddled under the castle of the great noble, who maintained his position by military force. As yet the state was unable to insure peace and safety for poor and rich alike. Without the organized power of a state created for the common weal, of course the strong man preyed on the weak and took what he wanted.

In like manner, we found very recently that, in the

field of transportation, the large shipper or the powerful city held the mastery, quite in disregard of the rights of the small shipper or the neglected city. Then came the warfare against discriminations, much to the relief of the railway itself. Now, under the regulation of the government, the large and the small are treated alike.

That is, we have been applying the great principle of liberty under law. Under a just law, the individual finds protection, and therefore far more liberty than when he was the unprotected prey of the larger interests. If I am not very much mistaken, we are now about to extend the same principle of liberty under law to the world of money, credit and banking.

III

POLITICAL CONTROL

There is a general agreement among bankers and experts that the establishment of a National Reserve Association would cure the foregoing evils. The general principles on which it is based are undoubtedly sound. It is to be emphatically stated that it is not a central bank; it does not propose centralization of our credit system. On the contrary, it aims to create cooperation among all the banks, for the common defense. It is a coöperative agency, aiming at a decentralization of credit and the preservation of the individuality of the small bank.

While there has been, on the one hand, a very general acceptance by experts of the proposal for a National Reserve Association, on its merits, yet, on the other hand, there has arisen from intelligent and public-spirited men a belief that the plan, good enough in its purely banking and credit analysis, may not sufficiently protect the public from either (1) selfish political control, or (2) from the domination of the so-called "money power."

So general is the acceptance of the basic principles of a National Reserve Association that Ex-Governor Folk has put forth a plan identical with it, except that it substitutes a government agency for the national board. It provides that the governor of the institution shall be appointed by the President of the United States, and be removable by him at any time; that fifteen of the twenty-one directors of the national board shall also be

appointed by the President, subject to the approval of the United States Senate. These suggestions of the distinguished Ex-Governor of Missouri are at variance with the very principles on which he bases his criticism of the National Reserve Association. He agrees with all of us in holding that the control of our credit system should be entirely free from political influence; and yet he proposes only those changes in the plan which would be certain to inject the most effective political control. Against his proposals we might fitly quote his own words: "Memory of the last Central Bank that Andrew Jackson fought, its corruption of members of Congress and attempted control of the government, will prevent this experiment being tried again in this country." With this statement we are all in hearty agreement; and it is reason enough why we should not make the officials or directors of the National Reserve Association political appointees, or a part of the spoils of a national campaign.

Indeed, if you look closely at any plan which proposes to place in the hands of "the people" the control of the technical and involved questions of credit and banking, you will find it only another way of contriving to throw the problem into politics. Monetary and banking questions are too complicated to be trusted to any other than experts; they should not be settled by a counting of noses; and, I may add, the business men of this country will throw themselves solidly against any plan which involves political control.

IV

FINANCIAL CONTROL

Quite recently, Mr. J. J. Hill expressed a fear that, while the National Reserve Association would provide a much-needed reform, it was not sufficiently protected from control by the "money power." Certainly no plan would be accepted which was not so protected. In that we can all agree. How fully to protect the National Reserve Association from ambitious financial control is a point needing careful and serious consideration.

(1) In the plan of a National Reserve Association, as generally known, three-fifths of the directors of the local association are to be chosen on the principle of one bank, one vote, whether the bank is large or small, a

bank having a capital of $25,000 counting as much in the result as one having a capital of $25,000,000. The other two-fifths are to be elected on the basis of capitalization, a bank casting votes in proportion to its holdings in the National Reserve Association. So far, the balance of power rests with the small banks, independent of capital.

The directors of the branches (composed of local associations) are to be similarly chosen. If there were twelve associations, there would be twelve directors, one for each association. Then eight directors (two-thirds of the twelve) would be elected by proxy-holders chosen by banks voting according to their holdings in the National Reserve Association. In addition, four directors (one-third of the twelve) would be chosen from men not engaged in banking. Thus, of the twenty-four, only eight (or one-third) would represent a voting force of capital. That is, two-thirds of the directors would be chosen independently of the size of the banks.

The fifteen districts, each possessing local self-government, are then to be federated in a national board of forty-five members: one from each district, independent of the capital of the banks therein, or fifteen in all; twelve chosen according to shares held in the National Reserve Association; twelve more elected from men not engaged in banking; and six *ex-officio* directors, including a governor and two deputies, and the Secretary of the Treasury, the Secretary of the Interior and the Comptroller of the Currency. Here, again, the balance of power does not lie with those elected on the basis of capital.

Now, would such an organization lend itself to control by the "money power"? Mr. Hill has said that, in a local association, a few big banks could combine to elect the two-fifths chosen on a basis of capitalization; and has suggested that, by subscribing $1,000,000 of stock, forty small banks, each of $25,000 capital, could be established so as to control the other three-fifths, chosen on the basis of one bank, one vote. Such a contingency may be possible; but it must be regarded as only very remotely possible. It is almost inconceivable that forty (or any considerable number of) small banks would be created purely for voting purposes, when by the very fact of their non-existence today they would be admittedly

unprofitable to their owners. So expensive, open and cumbrous a method of obtaining control would defeat itself. Moreover, it would be easy (by the act) to forbid voting privileges to any banks established within six or twelve months before an election of directors.

It should be remembered, however, that to give a small bank of $25,000 capital the same power to choose directors as that of a bank with $5,000,000, is to run the risk of depending on the less experienced banking judgment of the country. By the very fact of being large and successful a bank discloses the efficient quality of its managers; and a large bank can always afford to engage the best ability. It goes without saying, therefore, that the experience and judgment of a large bank is usually more to be considered than that of the small institutions; and this is well recognized in the relation established voluntarily between small correspondent banks and some large bank. As men of affairs, we should treat this question with business common sense, and not be urged by baseless clamor to propose legislation merely for "window-dressing" purposes. The real question to be asked is: Is it right, and is it adapted to the purpose of placing our currency and credit on a sound and permanent basis?

(2) Yet, no doubt, there remains the fear of control through the ownership of stock in many subscribing banks. Indeed, the holding company has seemed to afford an effective means by which a majority of stock in an unlimited number of banks may be acquired by a few men with enormous fortunes, who would thereby be able to control the National Reserve Association. In spite of the fact that only a minority of directors could be chosen on the basis of stockholdings, this fear of domination seems widespread. Now, if the value of the National Reserve Association is admittedly great, it should be opposed only on the assumption that means for preventing stock control are absolutely impossible. If the method of electing directors explained above is not sufficient protection (as many think), there are additional methods available for removing this fear beyond a question of doubt.

If it is really believed necessary to go to this length, it would be feasible to reduce a bank's voting-power for directors by the amount of its shares owned by

any person, trustee, corporation, or holding company, owning shares in any other bank. To furnish the practical means for carrying out this provision it would only be necessary to require as a condition of admission to the National Reserve Association the filing by each bank of a report giving the name and number of shares held by each shareholder; and to make criminal the attempt to escape this law by means of dummy shareholders.

(3) But, for the sake of the argument, let us suppose that the "money power" would be able to obtain control of the National Reserve Association by electing a majority of the national board, what could it do with it? Now, what is really meant by "Wall Street"? It is a market for securities. Those interested in speculation, in buying or selling stocks on margin, in floating bonds by means of syndicates, and the like, obviously are the ones meant by the "money power." If these persons succeeded in gaining control, what could they do with it? Evidently those who fear the influence of financial control have not fully understood the plan. The National Reserve Association is permitted to rediscount, not for the public, but only for banks; and the kinds of paper held available are short-time notes or bills arising out of commercial transactions. That is, stock-exchange collateral is discriminated against. Only in a serious emergency could such collateral be used; even then, it must be composed of satisfactory securities; moreover, these securities could be accepted only with the consent of the governor, the executive committee and the Secretary of the Treasury; and, finally, the loan must be the direct obligation of the borrowing bank, endorsed by its local association. How, then, is it conceivable that the institution could be used by the "money power" in floating any stock, or investment scheme? The inability to borrow on securities—although it may sometimes be a great hardship to legitimate borrowers—is, in my judgment, conclusive reassurance to those who may fear evil financial control.

(4) There is, however, a still stronger reply to be made. Keen students of the situation as it exists to-day see that—as before explained—we now have practical centralization in our credit system. They would be vigorously opposed to accepting any plan which

would make this present situation permanent. In a time of stress, when fully "loaned up," a small bank—and even very large banks in our reserve cities—can ask for aid and funds from a central correspondent only as a favor. If this favor is granted, the recipient is under obligation to the central correspondent. That is, we have today a form of feudalism in our credit system, by which the weaker are kept in dependence on the larger institutions.

Now, what is the remedy? Obviously, only that kind of reform which will destroy this dependence, and give the aid to the smaller bank (if it has satisfactory paper) as a right, and not as a favor. This end is precisely what the National Reserve Association is intended to accomplish. When the needy borrowing bank, be it large or small, can go to its local association, or to its district branch, and get exactly the same treatment as any other bank, the day of special favors, and of feudal dependence on a superior institution, will have passed. Men do not like to go down on their knees for special favors; and when that is no longer necessary the present form of unregulated centralization will have disappeared.

(5) Finally, the question may arise—if the plan of the National Reserve Association will tend to divert idle funds from the central reserve cities, especially from New York; reduce the amount which can be loaned at call on the stock exchange; direct capital more or less away from speculative loans to the discount markets for legitimate commercial paper; and break up the present feudal dependence of smaller banks upon very large ones: Why do not the large banks in the central reserve cities oppose the plan with all their energy? It may be suspected that there is some hidden reason why they are not openly opposing banking reform; or that there will be some "joker" in the bill laid before Congress. Probably this thought has been present in many minds.

No doubt, however, on this question has ever arisen in the minds of any managers of large banks who have passed through crises like those of 1893 and 1907. In an emergency, or crisis, the large banking institution finds itself confronted with exactly the same sort of difficulty, the same restrictions on its power to make new loans, the same inability to provide loans to old

customers, as those which confront the small institution; only, it may be said that the difficulties, although of the same kind, are greater, harder to meet, and carry with them larger possibilities of disaster. For instance, a local bank in Missouri, or Kansas, may find itself "loaned up" to its limit, and yet in an emergency additional demands for loans from merchants and farmers are pressing hard. Its duty is to serve the local community; but under the present inelasticity of credit the bank is bound hand and foot. If it fails to use good judgment, or to render aid to legitimate customers, it would cause failures throughout its constituency. Its only help is from its large correspondent bank, probably in St. Louis, Chicago, or New York. So far the facts are clear.

Now, how is it with the large bank having hundreds or thousands of small correspondent banks looking to it for favors, or funds, in time of stress? As these are scattered over a wide territory, the accumulated demands from correspondent banks, when trouble comes, are something tremendous. The failure to respond to aid would, when trouble comes, break down a local bank and carry with it all its customers. That is, the large bank has exactly the same kind of thing to meet as the small bank, only on a larger scale, with immensely greater responsibilities. If the small bank, therefore, would get relief out of a National Reserve Association, how much more would it be to the interest of the large bank to seek the establishment of such an agency. The common sense of the matter is, of course, that advantages from such a plan would inure to all banks, small or large. In a storm on a rocky coast, when two boats, one small and one large, are using all their seamanship to protect themselves from disaster, a shipwreck of the larger would carry distress to more families throughout the land than that of the smaller ship. The suffering of any one of ten persons on the small boat is, of course, as poignant as that of any one of a thousand on the big boat; but the full extent of the ruin caused by the latter is very much greater. That is, aids to safe navigation—lighthouses, buoys and charts—are quite as much to the interest of the large, as of the small, ship. But suppose that the smaller boat was in tow of the large

boat; then, when the larger ship went ashore, in fog or darkness, it would carry the small one with it. Similarly, the system which enables banks to aid their customers with loans in storm and stress is needed even more by the largest, than by the smallest, banks; and the preservation of a large bank protects the smaller correspondent banks.

Injurious financial control, then, should be made impossible; but preventive measures should be based on a real and expert knowledge of the organization of credit as it now is—practical centralization—and as it ought to be—actual coöperation among all banks in the common interest.

THE OBJECTS OF THE LEAGUE

The National Citizens' League for the Promotion of a Sound Banking System, under whose auspices this address is published, has no bill of its own; it is open to suggestions from any source. But it presents the following objects to be attained, which it hopes to have incorporated into law:

1. Coöperation, not dominant centralization, of all banks by an evolution out of our clearing-house experience.

2. Protection of the credit system of the country from the domination of any group of financial or political interests.

3. Independence of the individual banks, national or state, and uniform treatment in discounts and rates to all banks, large or small.

4. Provision for making liquid the sound commercial paper of all the banks, either in the form of credits or banknotes redeemable in gold or lawful money.

5. Elasticity of currency and credit in times of seasonal demands and stringencies, with full protection against over-expansion.

6. Legalization of acceptances of time bills of exchange in order to create a discount market at home and abroad.

7. The organization of better banking facilities with other countries, to aid in the extension of our foreign trade.

You may become a member of the League upon payment of one dollar. The proceeds of this membership fee will be devoted exclusively toward defraying the expenses of the campaign. All remittances should be made to

THE TREASURER,
National Citizens' League,
223 W. Jackson Blvd.,
Chicago, Ill.

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